

FRAUD & INTERNAL CONTROLS IN NONPROFIT ORGANIZATIONS

by

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## **Abstract**

This thesis examines several cases of fraud that has occurred in nonprofit organizations across the United States. It also looks at what fraud is and how it affects nonprofit organizations. As well as what can lead loyal volunteers and community members to commit fraud in their local nonprofit organization, thereby reducing the amount of resources the nonprofit has to work towards its mission in the community. Finally, it looks at what internal controls can be put in place by nonprofit organizations to reduce their fraud risk.

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## Introduction

Nonprofit organizations make up a large part of communities around the United States. Even though nonprofits work is for public benefit that does not stop both individuals and nonprofits from committing fraud. Nonprofits try to put the majority of their resources towards their mission; often leaving few resources for internal controls that can help them reduce their fraud risk. This thesis will identify several cases of fraud that has occurred across various types of nonprofit organizations and look at why and how fraud occurs and what can be done to help reduce the risk of fraud occurring.

## Nonprofit Defined

A nonprofit organization is an entity whose purpose is generally for public benefit and not for profit generation or equity maximization. Nonprofits do not distribute earnings to members, directors or officers. According to the FASB Accounting Standards Codification glossary the definition of a not-for-profit entity is

An entity that possesses the following characteristics, in varying degrees, that distinguish it from a business entity:

- a. Contributions of significant amounts of resources from resource providers who do not expect commensurate or proportionate pecuniary return
- b. Operating purposes other than to provide goods or services at a profit
- c. Absence of ownership interests like those of business entities.

Entities that clearly fall outside this definition include the following:

- a. All investor-owned entities
- b. Entities that provide dividends, lower costs, or other economic benefits directly and proportionately to their owners, members or participants such as mutual insurance entities, credit unions, farm and rural electric cooperatives and employee benefit plans.

The nonprofit sector in the United States is about 5.4% of our gross domestic product in 2012 (National Council of Nonprofits). The sector employed 12.3 million people in 2016, accounting for 10.2% of private sector employment (Bureau of Labor Statistics).

**Types of nonprofit**

There are many types of organizations that are classified as a nonprofit. Under United States tax code there are over 25 categories of nonprofits. These categories include human service organizations, schools, health care providers, cultural institutions, community development corporations, amateur athletic organizations, affordable housing, and research laboratories. The majority of nonprofits fall under these categories.

**What is fraud and who commits it**

Fraud, as most commonly defined in the United States, is a false representation of a matter of fact; whether by words or by conduct, by untrue or misleading allegations or by concealment; that deceives and is intended to deceive another so that the individual will act upon it to their legal injury (Ross 2016). Misrepresentation is a key component of fraudulent behavior.

Fraud experts often refer to the Fraud Triangle, a model created by Donald Cressey, as a way to explain the factors that cause individuals to commit fraud. The three components, which when combined lead to fraudulent behavior, are pressure, opportunity, and rationalization (Association of Fraud Examiners). Pressure is the first component and often involves financial problems stemming from debt, an addiction, or risk of not meeting goals. The second component is opportunity, which is the method or ability to gain undetected access to the nonprofits resources. The third and final component is rationalization, which involves psychologically and emotionally justifying the fraud as acceptable behavior based on a particular set of circumstances. Common rationalizations include that the stolen item will be returned, that the fraudster is entitled to the item taken due to unfair compensation, or the betterment of the fraudsters family situation (ACFE 2018).

Embezzlers or fraudsters are often typical individuals who do not act like criminals. While many times fraudsters are undetectable there are a few types and profiles that raise suspicion. Employees who are financially stressed, disgruntled, living above their means, and are compulsive about their responsibilities should be looked at more closely. Several cases of fraud below provide evidence that individuals in the aforementioned categories are more likely to commit fraud.

### **Types of Fraud**

The ACFE splits fraud into three categories: internal fraud, external fraud and fraud against individuals. Internal fraud is defined as “the use of one’s occupation for personal enrichment through the deliberate misuse or misapplication of the organization’s resources or assets” (ACFE 2018). Internal fraud occurs when an employee commits fraud against their employer, and is the main focus of this paper. External fraud occurs against a company from an outside entity, such as a vendor or customer. Lastly, fraud against individuals is when an organization defrauds an individual in schemes including identity theft, Ponzi and phishing schemes.

Internal fraud can be broken down further into three categories: asset misappropriation, corruption, and financial statement fraud. Nonprofits are most susceptible to asset misappropriation, which includes theft of cash, fraudulent disbursements, and misuse of assets (Archambeault 2015). Corruption includes bribery and conflicts of interest, while financial statement fraud includes the misstatement of assets and revenues, improper valuations and improper disclosures. According to Edward McMillan’s “Preventing Fraud in Nonprofit Organizations”, nonprofits are most susceptible to fraud in four specific areas: checks mailed to the organization's offices from contributors, advertisers; printing expenses; postage expenses;

and personnel related expenses including wages, payroll taxes and employee fringe benefits, all of which fall under asset misappropriation.

## **Fraud in Nonprofits**

A study done by Deborah Archambeault, Sarah Webber and Janet Greenlee looked at occurrences of fraud in nonprofits that were reported in press reports from 2008 – 2011 and found a fraud loss by nonprofits of \$27.9 million. This only accounts for fraud that was publicized and detected, so in reality that number is likely much higher. Among their other findings was \$22.8 million in fraud that committed by the nonprofit, victimizing the public. The difference between these two categories is the first group's activities are mainly wide access activities, such as misappropriation, that could be conducted at any level within the organization and fall roughly under the ACFE's asset misappropriation category. The second group's activities are mainly limited access activities, such as corruption and financial statement fraud that are not typically accessible by lower and mid-level employees.

### **Fraud Examples:**

One area of nonprofits that can be especially susceptible to fraud is amateur athletic organizations. Over 30 million children participate in youth sports with over 14,000 youth sports organizations in the United States ranging from little league baseball to USA water polo (Paddington 2016b). The smaller and more local types of leagues are generally run by parents who often have little financial or accounting experience, thereby making fraud detection less likely. Other types of nonprofits are susceptible to fraud as well and factors such as size and how long an organization has been around do not make an organization any less susceptible.

**Kent Little League**

One example of a case of fraud is at the Kent Little League. The Kent Little League is a youth baseball and softball organization in Kent, Washington. In 2013 the league president Greg Whitcomb attempted to use the league debit card to purchase envelopes and was denied. Whitcomb had been sent financial reports from the treasurer, Kevin Baker, which had shown the league had a \$227,000 checking account balance. Baker's children had played in the league since 2007 and he had been the treasurer for much of that time as well. In 2011 Baker lost his job, got a divorce, his sons moved to Idaho, and his grandfather died. In addition to these personal struggles Baker spent \$100,000 to buy a bar, which ended up failing. Between 2011 and 2013 Baker embezzled more than \$200,000 from Kent Little League in 271 separate transactions, including cashing cashiers checks and withdrawing cash from ATMs using the little leagues debit card (Hunter 2015).

Kent Little League had been raising that money for a decade in an effort to purchase their own baseball and softball fields. When Whitcomb was denied after trying to purchase envelopes he looked into the bank accounts and found missing money and reported the theft to the Kent Police Department (Hunter 2015). In 2015 Baker pleaded guilty to six counts of first-degree theft and two counts of second-degree theft. He was ordered to repay the league \$208,743 and sentenced to twenty-two months in jail (Pennington 2016b).

This case shows how the three aspects of the fraud triangle can come together. First Baker had financial pressure after losing his job and then opening a bar, which proceeded to struggle causing even more financial problems. Second, Baker had the knowledge of how to get around the few controls that were in place. He told the judge during his guilty plea that "I know the bylaws of the Kent Little League that transfers are supposed to have double signatures but



they just don't look at that. As far as the ATM, anyone can make withdrawals if you knew the pin" (Hunter 2015). Thirdly, Baker was able to rationalize the fraud as a loan that he needed in order to acquire additional funds for his bar.

### **Triboro Youth Soccer Club**

The Triboro Youth Soccer Club, in Whitehall, Pennsylvania, is a soccer club whose goal is for players to develop the skills they need for the future and maximize their soccer experience. In 2013 Triboro got a new president who hired an attorney to look over the management of the club. After examining the books and having the retainer check bounce, the attorney became suspicious and upon further investigation found that 80% of the clubs funds were missing. The current treasurer Brian Farley had embezzled \$120,000 over a six-year period.

Farley had been the long-time treasurer of the club and his son and daughter had played in the club. After Farley lost his job on Wall Street, he started making loans to himself and was "basically paying off his bills and living as if the club's account were his own," according to the assistant district attorney who prosecuted the case, Steven Luksa (Pennington 2016b).

Additionally, Farley used the clubs bankcard for personal purchases. Farley pled guilty to felony theft and was sentenced to five years of probation, immediate repayment of \$55,000, an apology to the parents and children of the club, and to make monthly payments to repay the remaining \$65,000. After Farley's embezzlement was found, the club put additional policies in place to prevent this from happening in the future. Coaches and other club members have to have invoices and receipts for all expense, regardless of size and two board members review the book monthly.

**Clinton Valley Little League**

The Clinton Valley Little League, in the Clinton Township of Michigan, is a youth baseball organization. In 2014 new board members accessed to the league's bank statements and found checks written to then treasurer, Karen Dimitrie. Dimitrie and her husband were pillars of the community. Karen Dimitrie was the library clerk at the elementary school and active in the neighborhood church and Frank Dimitrie was the president of Clinton Valley Little League and coach of the freshman high school baseball team. Karen Dimitrie had been treasurer of the league for six years but had never actually kept any records or books. A police investigation uncovered \$300,000 in embezzled funds. The investigation found that checks would be written directly to the Dimitries and that there was little separation between their personal funds and the leagues funds. Additionally it was found that Karen Dimitrie had a gambling addiction and was the reason for some of the embezzlement (DeFrank 2015). Karen Dimitrie pled guilty and was sentenced to five years of probation and restitution of \$175,000 (Pennington 2016a). The amount of the restitution is lower than the amount embezzled because Karen Dimitrie states that she had already repaid \$100,000 to the league (DeFrank 2015).

**Vista Pop Warner**

Vista Pop Warner, a youth football and cheerleading organization in Vista, California, has been subjected to multiple instances of embezzlement. In 2003, a volunteer parent treasurer embezzled \$37,000 and was sentenced to 120 days in jail and restitution of the stolen amount. More recently was an embezzlement in 2014 by Rachel Owens, the then current volunteer treasurer. In 2015 Owens applied for a line of credit with the organization president's information, leading the board to take a closer look at the accounting records. An investigation by the San Diego Sheriffs office identified \$114,000 was that embezzled (Figueroa 2016).

Owens, who had high amounts of credit card debt, embezzled the funds by writing checks to herself and taking cash raised at league fundraisers. The embezzled funds were used to pay down her high credit card balances and for other living expenses. In 2016 Owens pled guilty to five felony charges including embezzlement, identity theft and grand theft. She was sentenced one year in jail, five years of probation and restitution of the full amount.

### **Somerville Homeless Coalition**

The Somerville Homeless Coalition in Somerville, Massachusetts is an organization that aims to provide homeless and near homeless individuals and families with supportive services and tailored housing solutions. Its primary goal is to help those serviced obtain and maintain affordable housing. In November of 2015, a board member noticed unusual activity in the accounting records. Further inquiry resulted in discovering that the chief operating officer, Warren McManus, had been embezzling funds. McManus had embezzled approximately \$108,000 over 18 months by adding money directly to his paycheck, using the organization's credit card for personal expenses, and adding his middle-aged son to the group insurance plan.

After the embezzlement was discovered, McManus was fired and in March of 2016 the fraud was reported to donors and to the United States Department of Housing and Urban Development (HUD). In 2017 HUD then referred the case to the Office of Inspector General. In January of 2018, the Boston Globe reported that McManus had spoken with federal investigators and "signed a statement concurring with several allegations, and agreed to pay back \$61,854," no jail time or probation was listed as part of the statement signed with investigators. Additionally, the Boston Globe corresponded with McManus who stated that he "typically worked seven days a week and took only three holidays a year ... he generally paid himself extra for the time he had

earned.” McManus also admitted to putting his diabetic son on the plan “for a short time” but then forgetting to take him off.

### **The Arc in Hawaii**

The Arc in Hawaii is committed to helping Hawaii’s people with intellectual disabilities secure the power to choose where and how they live, learn, work and play in the community. In 2017, a routine audit by accounting firm KKDLY LLC found misappropriated funds of approximately \$633,000 for the June 30, 2016 fiscal year (KKDLY, 2017). After the report Arc filed a case with the Honolulu Police Department. An investigation uncovered that Lola Amorin, a senior staff accountant who had been working at Arc for thirty years, had embezzled \$6,969,165 over a nineteen-year period (Nagaoka 2017).

Amorin embezzled almost \$7 million by taking blank Arc checks and turning them into cashier’s checks, which she then deposited into her personal account. Amorin also used Arc checks to make her personal credit card payments. Investigators were not able to find where all the money went but were able to find four properties in Oahu, the Big Island and Las Vegas that Amorin purchased with the embezzled funds. Amorin was charged with two counts of theft, two counts of computer fraud and one count of money laundering and was sentenced in August 2018 to twenty-five years in prison and repayment of the entire amount stolen in addition to paying the Hawaii department of taxation unpaid taxes of \$337,553 (Daranciang 2018).

### **Why does fraud in nonprofits occur?**

Fraud in nonprofits can be committed by anyone. In youth sports organizations, it is often unpaid board members who are highly respected in their communities. In larger nonprofit organizations, even an executive level employee can commit fraud. Fraud can be committed for many reasons. One of those reasons is debt, especially gambling debt. Another reason fraud

occurs is the feeling of being owed something from the organization. When an individual gets into a stressful financial situation, have the opportunities and means to obtain funds discretely from the organization, and are able to rationalize the fraud, fraud occurs.

Youth sports organizations are often not audited and have weak or nonexistent internal controls. Due to this the fraudsters can often embezzle funds for a long periods without detection. Not all nonprofit organizations are required to be audited. Currently, if a nonprofit organization expends \$750,000 or more in federal funds in a year the Office of Management and Budget requires a Single Audit. In addition to federally mandated audits, states have varying requirements for when nonprofit organizations need to be audited (National Council of Nonprofits 2018). While there are many nonprofit organizations that receive federal or state funding not all do, leaving a gap in nonprofit entities that are audited.

Nonprofit organizations are vulnerable to fraud more than for-profit organizations for several reasons. First, those overseeing nonprofit organizations have access to considerable funds, as can be seen several of the cases above. Additionally, nonprofit organizations often have high levels of trust in those working for them and from the public as seen in the Clinton Valley Little League case.

### **Effects of fraud**

While the effects of fraud can be damaging for any organization, for nonprofits they can be even worse. Many nonprofits are small and have limited capacity to implement sophisticated internal controls. Because resources are limited, even small frauds, can have negative impacts on the organization's ability to work towards its mission (Archambeault et al. 2015). Fraud can also have a negative reputational effect, which can significantly decrease donor contributions. In addition to donations, fraud can also lead to a decrease in federal funding. In extreme cases the

decrease in revenue from these sources can result in a nonprofit being forced to cease its operations. A study done by Deborah Archambeault and Sarah Webber found that when executives commit fraud, the organization has lower chance of survival. Additionally, nonprofit organizations that are more established are more likely to survive fraud, because they often have more established controls and procedures in place (Archambeault et al. 2018). For several of the youth sport organizations above, the fraud led them to scramble for money to stay afloat, often relying on extra money from board members and extra donations of time and money from local sponsors (Pennington 2016a).

A study done by Christine Petrovits, Catherine Shakespeare and Aimee Shih, in *The Causes and Consequences of Internal Control Problems in Nonprofit Organizations*, found that weak internal controls over financial reporting and public support and government contributions received are negatively associated. Leading the authors to conclude that saving on short-term administrative costs can “ultimately have negative consequences on the organization’s donor support and, thus, the organization’s ability to deliver services” (Petrovits et al. 2011). Many nonprofits are aware that donor contributions decrease after contributors become wary of the organizations management. As a result some nonprofits choose to ignore early warning signs of fraudulent behavior and in the most extreme cases, fail to act on it when discovered. This fact makes having the proper internal controls in place even more important.

## **Steps to Preventing Fraud in Nonprofit Organizations**

### **Internal Controls**

Internal controls are an important part of any company or organization’s efforts to curb fraud and mistakes in accounting and financial areas. Public for-profit companies have been subject to internal control audits since the passing of the Sarbanes-Oxley Act (SOX) in 2002.

While SOX was specifically geared towards publicly traded companies, some nonprofit organizations have implemented various aspects of SOX in an effort to improve accounting processes and help curb errors and intentional misconduct. Internal controls are defined “as processes put in place by management to provide reasonable assurance regarding the achievement of effective and efficient operations, reliable financial reporting and compliance with laws and regulations” (Petrovits et al. 2011).

The framework from COSO defines five components of internal control: control environment, risk assessment, control activities, information and communication, and monitoring activities. The control environment is the basis for all other aspects of internal control and includes the integrity, ethical values, and competence of the entity’s employees and is often seen as the tone set at the top. The next area, risk assessment, is management’s assessments of business risks and how they can be managed. Next are control activities, which are specific actions that management and employees take to ensure management’s directives are carried out. Control actions are used for preventing, detecting and correcting errors and fraud that could occur in an organization. The next component is information and communication, which involves managers and employees having access to timely, reliable and relevant information. The final component is monitoring, which involves ongoing evaluation of internal controls.

Since nonprofits do not fall under SOX, except for provisions 806 and 802 on whistleblower protections and document destruction policies, their regulatory oversight mainly is found in section 501(c)(3) of IRS code and state-specific nonprofit laws that may exist (Petrovits 2011). Some nonprofits, mainly those receiving federal funding over \$750,000 a year, do undergo additional oversight through a Single Audit. The Single Audit focuses on providing

assurance that federal funds are being used appropriately and organizations are complying with federal regulations.

In Archambeault et al., study, they concluded that 60% of frauds occurred at the executive level, ever stressing the importance having strong board oversight and an audit committee. Their study also found that nonprofit organizations can benefit from other controls such as separation of duties, employee background checks, a confidential fraud reporting system and education on the harm fraud causes to an organization (Archambeault, 2015).

## **Conclusion**

Fraud affects all organizations, but fraud that occurs in nonprofit organizations affects more than just the organization itself. Nonprofit organization missions are for public benefits and when fraud impacts them it also impacts the people they help. This is shown in all of the cases presented above. Fraud at the Kent Little League led to them not being able to purchase the baseball and softball fields they were close to buying. The \$7 million taken from Arc in Hawaii reduced the amount of funds available to help individuals with intellectual disabilities with housing. Nonprofits can work to reduce the threat of fraud by having appropriate internal controls in place and educating the volunteer board members on the effects fraud can have and proper procedures. Additionally, more oversight and training can be applied to nonprofit organizations, especially those that are smaller and run by volunteer parents like youth sports organizations. Oversight and training programs can both come from the state and county level. Overall, the more nonprofit organizations invest in creating strong internal controls and cultures, they less likely they are to have fraud occur causing them to lose funding, reputation and even possibly shut down.



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